BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
J. H. MARTINUS & SONS)

Appearances:

For Appellant: Philip G. Sheehy, Attorney at Law

For Respondent: Frank M. Keesling, Franchise Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of J. H. Martinus & Sons, a corporation, to his proposed assessment of an additional tax in the amount of $263.25 for the taxable year ended December 31, 1936, based upon the income of the corporation for the year ended December 31, 1935.

The Appellant was engaged during the year 1935 in the business of owning and operating farm lands and raising live-stock, its operations extending over about 4,666 acres of land owned by it and an additional 1,500 acres of land which it rented. Its officers and principal stockholders, S. N. Martinus President, Phillip R. Martinus, Secretary, and Jan H. Martinus, General Manager, were actively engaged in and devoted their entire time to the management and conduct of its affairs. Appellant kept its books of account and computed its income on the cash receipts and disbursements basis, itsincome year ending on the 31st day of December of each year.

During the year 1935, it was agreed at a meeting of Appellant's Board of Directors that S. N. .Phillip R. and Jan H. Martinus should receive salaries of $3,400 each for the year. During that year none of these individuals maintained a bank account in his individual capacity, but all funds of the corporation or funds belonging to them as individuals were on deposit in the Monterey County Trust & Savings Bank, King City Branch, in the name of J. H. Martinus & Sons. At all times during the year each of the three individuals had unlimited authority on his signature alone to withdraw funds from that account, either for the benefit of the corporation or for himself as an individual.

Although their salaries for the year as determined by Appellant were in the aggregate $10,200 and they might have withdrawn that entire amount from the funds on deposit, they elected to withdraw and actually withdrew only the sum of

$3,313.22. In Appellant's return of income for the year it deducted as salary paid the three officers the sum of $10,200, each officer reporting in his personal income tax return the receipt from the corporation of salary in the amount of $3,400. The Commissioner allowed to Appellant a deduction of only the amount of $3,313.22 actually withdrawn by the officers, disallowed the balance of $6,886.78 and levied his proposed assessment accordingly. The validity of this action of the Commissioner is the only question presented herein for our consideration.

Two reasons have been given in support of this action. First that the amount disallowed was not "paid" by the Appellant, within the meaning of Section 8(a) of the Bank & Corporation Franchise Tax Act and second, that the amount deducted by Appellant as salaries to the extent that it exceeded the amount allowed did not represent reasonable compensation for the services rendered, It is our opinion that the first reason by itself furnishes ample support for the Commissioner's action, so that it is unnecessary to discuss the second.

Section 8(a) authorizes the deduction of:

> "All the ordinary and necessary expenses paid or incurred during the income year in carrying on business including a reasonable allowance for salaries or other compensation for personal services actually rendered ..." (Underscoring added)

Section 11(d) of the Act provides:

> "The terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed hereunder."

These provisions compel the conclusion that since the taxpayer computed its income upon the basis of cash receipts and disbursements, the salaries which Appellant voted to its three officers constitute proper deductions from its gross income for the year 1935 only to the extent that they were actually paid during the year.

The Appellant contends that even though the amount in question was not disbursed from the corporation's bank account, it must be regarded as having been paid, inasmuch as the officers could have withdrawn the amounts due them at any time.

In support of this contention it cites several decisions of the federal courts and of the Board of Tax Appeals to the effect that amounts credited to a taxpayer and which may be drawn by him at any time are to be regarded as having been received by him. There is also cited article 16(d)2 of the Regulations issued under the Personal Income Tax Act of 1935, which is to the same effect.

We do not believe, however, that the rule set forth in

these authorities, commonly referred to as the "doctrine of constructive receipt," may be applied to permit a taxpayer reporting on a cash basis to deduct expenses in a period prior to that in which the actual disbursement took place; No authority has been cited approving such a procedure, and in the only cases which have come to our attention in which the question was raised, it was held to be without merit.

Massachusetts Mutual Life Ins. Co. v. United States, 288 U.S. 269, 274,275
Sanford Corporation, 38 B.T.A. 139

In the latter case the United States Board of Tax Appeals stated, at p. 141:

> "Constructive receipt is a principle sparingly applied. Perhaps it is never applied to the recipient's advantage because to do so would be contrary to the purpose of the rule. However, constructive receipt would not necessarily show payment by the corporation where, in fact, there was none. That is the situation here. The statute allows the deduction only where the dividend was paid within the taxable year. The petitioner could have declared and paid the dividend earlier, but it actually did not pay it within its taxable year. Consequently, it has not shown that it is entitled to the deduction."

We believe, accordingly, in view of this State of the authorities, that the word "paid" must be given its literal meaning and that the provisions of the Act do not permit Appellant to take deductions for expenses in advance of the actual disbursement of funds.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action of Chas. J. McColgan, Franchise Tax Commissioner! in overruling the protest of J. H. Martinus & Sons, a corporation, to a proposed assessment of additional tax in the amount of $263.25 for the taxable year ended December 31,1936, based upon the income of the corporation for the year ended December 31, 1935, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of November, 1939, by the State Board of Equalization.

Fred E. Stewart, Member
George R. Reilly, Member
Harry B. Riley, Member

ATTEST: Dixwell L. Pierce, Secretary